CASH CONVERSION CYCLE AND PROFITABILITY OF NIGERIAN SMALL AND MEDIUM-SIZED ENTITIES: AN EMPIRICAL ANALYSIS

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ABSTRACT

Purpose - The aim of this study is to report the results of an empirical investigation on the relationship between cash conversion cycle and firm performance of small and medium-sized entities in Nigeria. SMEs are potentials for Nigerian economy growth; contributing to gross domestic product, employment generation, poverty reduction and industrialization. Traditionally, SMEs are faced with significant financial constraints due to their inability to secure external financing. According to Ebben and Johnson (2011) many lenders and investors are reluctant to provide financing to SMEs because of the risk and cost involved. Thus, external financing tends to be difficult and highly expensive to SMEs. In addition to financial constraints faced by the SMEs, the global financial crises and credit squeeze is threatening the survival of many SMEs particularly in the developing economies. These relegate them to the use of internally generated funds and short term resources to finance operations by means of efficient working capital management. A shorter cash conversion cycle (CCC) is associated with increase in the firm's profitability because of the improvement in the efficient use of working capital whereas longer CCC hurts profitability. This indicates that a firm with shorter CCC is collecting its receivables as quickly as possible and delaying payments to suppliers as much as possible (Shin & Soenen, 1998; Lazaridis & Tryfonidis, 2006a). This results to high net present value for the firm cash flow and relatively high firm's value (Nobanee et al., 2011). CCC can be shortened by reducing the time cash is tied up in the working capital. According to Nobanee et al. (2011) CCC can be shorten by shortening the account receivables period (ARP) through speeding up collections, or by shortening the inventory holding period (IHP) through quick processing of order and selling of goods to customers or by lengthening the accounts payable period (APP) through slowing down of payments to trade creditors. The finding of study revealed insignificant negative association between CCC, IHP and APP with SMEs profitability. A statistically significant negative relationship was found between ARP with SMEs profitability. Also found is a significant positive relationship between firm size, leverage, growth opportunities and firm age with SMEs profitability.

Methodology - The study analysed panel data from the annual reports of 311 samples of non-financial and non-services Nigerian SMEs over a period of 7 years (2007 – 2013). The sample SMEs are selected from across the six Nigeria Geo-political Zones using stratified and convenience sampling techniques. Financial and services SMEs are excluded from the study due to nature of their business activities. The main variables of the study include the dependent variable return on assets (ROA) which serve as a proxy for the SMEs profitability. The independent variables includes CCC and its components; ARP, IHP and APP. Beside the main variables of the study, few control variables introduced in the study are firm size, leverage, sales growth and firm age.

Findings - The results of the regression estimations indicate that the coefficient of CCC are found to be negative and insignificant which implies that a decrease in the cash conversion period is associated with an increase in the SMEs' profitability. With respect to the three components of cash conversion cycle (ARP, IHP & APP); the coefficient of ARP was found to be negative and significant. This implies that, decrease in the accounts receivable period by one day is associated with a increase in the SMEs profitability. This means SMEs managers can create value for owners by decreasing the days of accounts receivable (García-Teruel & Martínez-Solano, 2007). Further, the coefficient of IHP shows an insignificantly negative relationship with ROA which indicates an increase in the inventory holding period is related to the decrease in the ROA. Similarly, the coefficients of APP across the models are found to be negative and insignificant. The coefficient of firm size shows a significantly positive relationship with firm's profitability (ROA) which implies that larger firms are associated with an increase in firm's profitability. Similarly, the coefficient of sales growth, leverage and firm age reports highly positive significant relationship with firm's profitability.

Keywords: Cash conversion cycle, profitability.

CONCLUSIONS

Overall, the result of this study shows that only accounts receivable period (ARP) supported the hypothesis. The findings concur with the working capital management theory which proposes shorter accounts receivable period with higher profitability (Deloof, 2003; Raheman & Nasr, 2007). The finding also suggests that managers can improve their firm's profitability by shortening the accounts receivable period (Deloof, 2003; García-Teruel & Martínez-Solano, 2007; 2008; Afeef, 2011). Further, other variable (CCC, IHP and APP) failed to support the hypothesis. The plausible explanation is that most Nigerian SMEs are associated with lack of managerial proficiency and poor management of resources (SMEDAN/NBS, 2012; Sunday, 2011; Ademola et al., 2013). Managerial incompetency might lead to poor financial management, particularly efficient working capital management. Also, Nigerian SMEs are associated with financial constraints (Okpara, 2011; SMEDAN/NBS, 2012). This affects their ability to employ skilled and competent personnel who can manage their resources effectively. Thus, the result of the study indicates that Nigerian SMEs with shorter cash conversion cycle and low growth opportunities hold more cash. This study contributes to existing literature on the relationship between cash conversion cycle with SMEs profitability in developing economies.

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